RAILROAD WEEK IN REVIEW

June 24, 2016

"We're stuck. The Fed is stuck. The ECB and the BOJ are stuck. The banks are stuck. Corporations are stuck. Asset managers are stuck. Financial advisors are stuck. Investors are stuck. Republicans are stuck. Democrats are stuck. Something's gotta give." — Ben Hunt, Epsilon Theory

"The freight market remains weak. Aside from respectable demand last week, volume has been rather soft with little evidence of the normal seasonal uptick." — John Larkin, Stifel

A friend close to the rail industry writes, "There really are no positive signs for traffic this year. Coal is toast, oil was a non event, etc. So this will be a time to see if rails can adjust to a declining market. If they make it to the end of the year, then I will remain optimistic." Yet in all of this he sees today's railroad leaders being more proactive in terms of creating customer value.

I think pre-1999 Conrail is the poster child for creating value out of a static traffic base. Hardly a day goes by without somebody referring to the Conrail practice of blocking for the distant node, and making yard managers responsible for their variable expense line, for example. My friend again: Conrail worked the costs, worked the traffic base around the edges, and didn't try to hit home runs. No home runs and not breakout stuff, just solid, incremental railroading.

Such was the take-away from WIR last week. I wrote, "The trends show the non-Class Is are better than the Class Is at beating the bushes for new carload business, and the Class Is are better than the non-Class Is at driving that business away. It doesn't have to be that way." To which a shortline leader of more than 30 years standing replies,

> You're right on the money. I've never seen anything like this environment where the industry needs quality new business (which will consist mostly of single-car merchandise traffic) and yet the Class Is are so opposed to doing anything differently. It's deeply concerning for the future and what it means for Class 2 and 3 operators who want to grow market share.

My Wall Street contacts are not enthusiastic. Cowen's Jason Seidl reports, "Year-to-date traffic remains well below last year's levels on sharp declines in coal, metals and crude." To which I add, and so is just about everything else that matters most to the shortline community. I see some hope for ag products, but, being weather and foreign-trade dependent, any up-tick forecast must be taken with a degree of caution.

As for the 2016 second quarter, Cowan writes that improved service metrics may be due to the fact there are fewer cars cluttering up the rails. Easy comps may provide the illusion of growth, but, as we've seen from the 5-year QCS comps I published last week, trends are generally down.

Because carload performance is uneven across commodity lanes, one must necessarily focus on on the merch commodities that are not cyclical, do not depend on the global economy or a weak dollar (steel, grain, ores) and have strong domestic markets (ferts, ethanol, plastics, frac sand, forest products, STCC 29 petroleum products from asphalt to LPG, and construction aggregates).

Two more trucking companies get negative reviews from the analyst community this week. Stifel's John Larkin takes Celadon to task for lower average freight revenue per loaded mile, fewer average miles per tractor, and more empty miles as a percent of total mikes driven. The company us shrinking its active tract count by two percent.

Covenant cuts its Q2 earnings estimate to the 20-cent range, down a third from its prior guidance, citing less price elasticity, rising fuel costs, and sequentially declining month-to-month asset utilization. Wolfe's Scott Group sees the truck business and "weak but stable," though it's tough to have confidence that we've cut our EPS enough for the other truckload providers."

Putting all this in context, the chief economist for the ATA says smaller fleets are adding capacity even as timing and magnitude of truck supply reductions are in question. Such capacity increase as there is comes in the form of more trailers than tractors.

Strength in smaller fleets implies stronger demand for truck transport from smaller firms in smaller markets, those missed by the trucking equivalent of Class I railroads. The small truck fleets have one advantage the shortline railroads lack: the truckers don't have to hand off loads to bigger truckers for the longer haul. The way to get around this is to sell short line to short line moves in their own equipment priced FAK. Minimizes Class I interference.

Canadian Pacific on Tuesday cut its second quarter estimates, citing lower-than-anticipated volumes in bulk commodities, such as grain and potash, the devastating wildfires in northern Alberta, and a strengthening Canadian dollar. As a result, second quarter revenue could be on the order of $C1.4 billion vs. $C1.6 billion, down 12 percent. Below the line, CP suggests adjusted diluted earnings per share of approximately $C2.00 and 62 operating ratio. For what it's worth, diluted earnings per share before buy-backs was $C2.36, putting the present estimate down 15 percent. And the OR was 60.9 a year ago.

In the press release, CP says it "remains confident in its business model and believes actions taken in the first half of the year – coupled with an anticipated improvement in commodity volumes – provide a path for the company towards meeting its full-year guidance." That could be a push. Credit Suisse says getting there would mandate a 22 percent EPS gain in the second half. CP reports second quarter results July 20.

KCS Chief Financial Officer Mike Upchurch told the assembled masses at the Citi's 2016 Industrials Conference that, were it not for foreign exchange rates and fuel surcharge revenue, the second quarter is about what was expected. The take-away, as we've heard before, is that

KCS wants to make a difference in things they can control. This applies to neither foreign exchange nor the price of diesel fuel.

Quarter-to-date grain loads are up 11 percent, thanks to better turns on a bigger grain car fleet serving a larger number of originating customers. STCC 29 petroleum products (mainly NGLs) and plastics pumped those loads up 29 percent; a certain industrial chemicals softness took the broader group down to an 11 percent gain. What KCS calls its Energy group (frac sand, coal, crude oil) drifted south by 12 percent; automotive loads were off seven percent. Not bad.

The Brexit vote is in and I for one take it with a grain of salt. Even though the Leave side won, it could still take years to become effective. Article 50 of the EU's Lisbon Treaty provides a process whereby a member can say it wants to leave, after with there is a two-year window for negotiating terms. It appears that under Article 50 the U.K. remains a member until its formal departure. And the two-year window can be opened further.

As of Friday morning, the Cameron Government hasn't mentioned any time frame, other than to say it will leave starting the clock to its successor. Former London Mayor Boris Johnson said Friday there is no need for the U.K. to rush. Which means we have at least two years for cooler heads to prevail and work out the details.

Geopolitical analyst George Friedman writes — accurately, I think — that "the argument for remaining in the EU was that the alternative was economic disaster. It made little sense to the opponents of membership to try to solve British problems through a close link to an organization experiencing regional economic disaster and organization-wide stagnation."

As a life-long Anglophile, I can't see the Brits perpetuating this Brussels-driven equivalent of taxation without representation, any more than I can seem them cutting off their noses to spite their collective faces. Business will do what business must do to keep their world of place where a man's word is his bond. [And, P.S., I think little a more distance from the madness of the EU will stand GWR and other Yankee operators of U.K. rails in very good stead.] Hail Britannia.

The 2016 BNSF Shortline Conference will once again be at the Worthington Renaissance in Fort Worth (I love these downtown locations), October 19-20. Further details will be coming in August, and BNSF solicits your input for conference topics. (I'd like to see one on how rates are made — mechanics, not specific numbers or commodities — and how shortline behavior can affect the elements of rate-making.)